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The Picture Should Brighten Further For Spain's Banking Sector This Year

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The prospects are looking good for Spanish bank ratings. Thirteen of the 15 banks we rate are on positive outlook, indicating that we could consider upgrades this year. Our unsolicited long-term sovereign rating on Spain is also on positive outlook.

The strong economic upswing and the real estate sector revival have created the conditions for banks' financial profiles to continue strengthening in 2018. The stock of problem exposures, originated during the downturn, should continue to decline organically, as it has since the end of 2013. However, compared to previous years, we see more potential for regulatory and market pressures to result in a more accelerated pace of divestments. We would view this positively. We expect credit losses to reduce, leading to some improvement--even if still modest--in bottom-line profitability. Banks will also likely keep accumulating capital and benefit from favorable funding conditions in a year when we expect the issuance of senior nonpreferred notes to gain further traction.

The domestic environment, however, is set to remain competitive. Although lending should finally resume, volume growth will not be so significant as to really change the pricing dynamics in the industry amid still ultra-low interest rates. Banks will therefore fight to preserve market share, which will most likely mean, at best, prices remaining where they are. This might also be the first year since 2014 that banks' net interest income does not decline, but revenues are likely to increase only modestly, if at all. Although lower credit impairments will result in better bottom-line profits, we expect domestic returns to remain generally below banks' cost of capital.

Overview

- Amid a stronger economy and real estate sector revival, Spain's banks stand to strengthen this year, which could lead us to consider upgrades. Of the 15 banks we rate, 13 are on positive outlook, as is the sovereign.
- We see potential for regulatory and market pressures to result in a more accelerated pace of disposals of NPAs.
- With the domestic environment likely to remain highly competitive, domestic returns will generally stay below banks' cost of capital, and the sector may consolidate further.
- The persistence of political uncertainty in Catalonia is the main risk to Spain's banks' positive momentum.

We continue to believe that banks may consider domestic consolidation to ensure the medium-term viability of their business models.

The main risk factor potentially clouding expectations is the potential negative impact of Catalonia's political crisis. Political uncertainty may persist, depending on the policy direction of the new regional government, which has yet to be formed. The most prominent risk we continue to see is that political confrontation may lead to a sustained drop in business and consumer confidence, especially in Catalonia. The performance of the real estate market in the region could also be at risk.

The National Economy Should Remain Supportive

The Spanish economy continues to expand rapidly. In 2017, Spain's real GDP growth exceeded 3% for the third consecutive year, employment grew by almost 3%, and real GDP returned to pre-crisis levels (2007). The broad-based recovery is likely to continue, also amid growing economic momentum in the eurozone. We forecast 2018 real GDP growth at a still-robust 2.7%--above the 2.0% eurozone average--and unemployment to decline to 15.6% from 17.2% year on year. Solid economic growth will also contribute to the country's fiscal rebalancing.

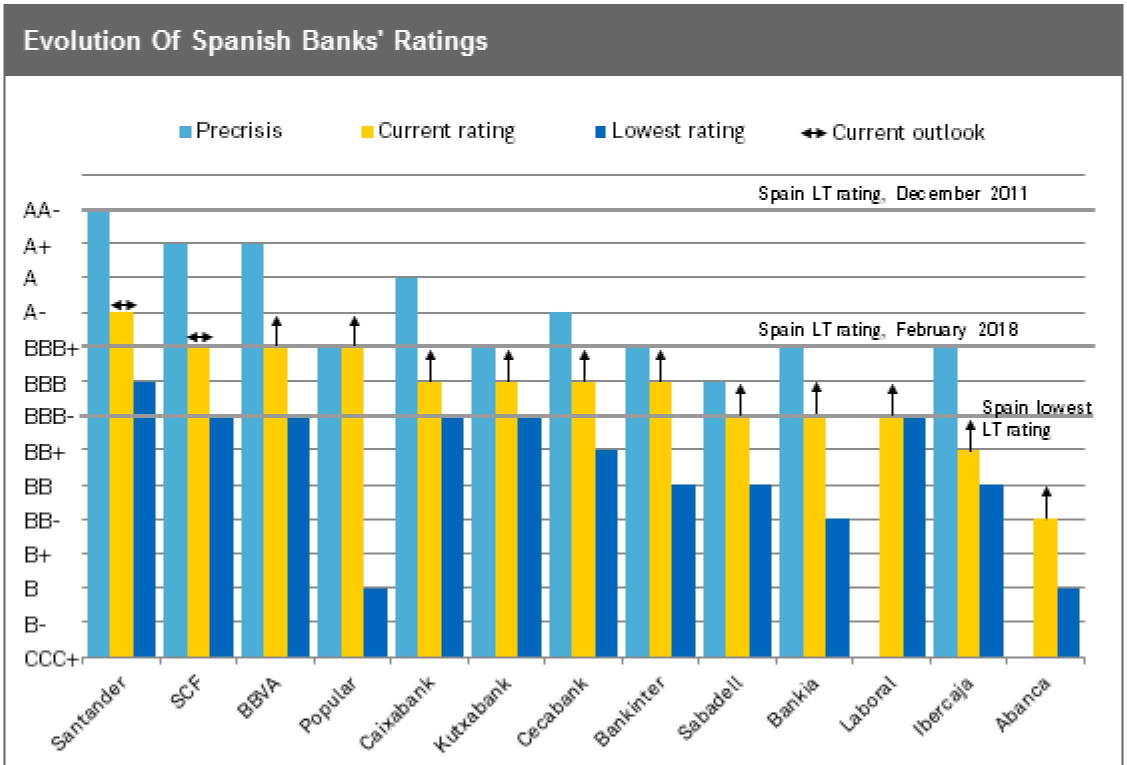
The escalation of political tensions in Catalonia in October 2017 had immediate negative consequences for the region's economic performance. So far, however, the knock-on effects at the national level have proved manageable because the rest of Spain has more than compensated for the softening of Catalonia's economy. The heightened political risks were not enough to trigger a revision of our positive outlooks on the sovereign and banks' ratings.

Prolonged political uncertainty in Catalonia, though, could start to weigh more on the region and country's prospects. The snap regional election results from December 2017, after the central government invoked article 155 of the Spanish Constitution, seem to indicate a split electorate. The reshuffle of votes was largely within each of the pro- and anti-independence camps. Similar to the elections in 2015, the former obtained the majority of seats in the regional parliament, but did not receive the majority of votes. Political uncertainty may persist depending on the policy direction of the new regional government. If it does, it could potentially hold back upgrades to banks.

Banks' Financial Profiles Will Continue Strengthening

The ongoing strengthening of banks' financial profiles--which we have reflected in upgrades over the last few years (see chart 1)--will continue in 2018. That said, even if we see more upgrades in 2018, most banks' creditworthiness will still be below pre-crisis levels. Broadly, we see positive developments on all fronts, but there's room for more-relevant progress in the workout of legacy problematic exposures.

Chart 1



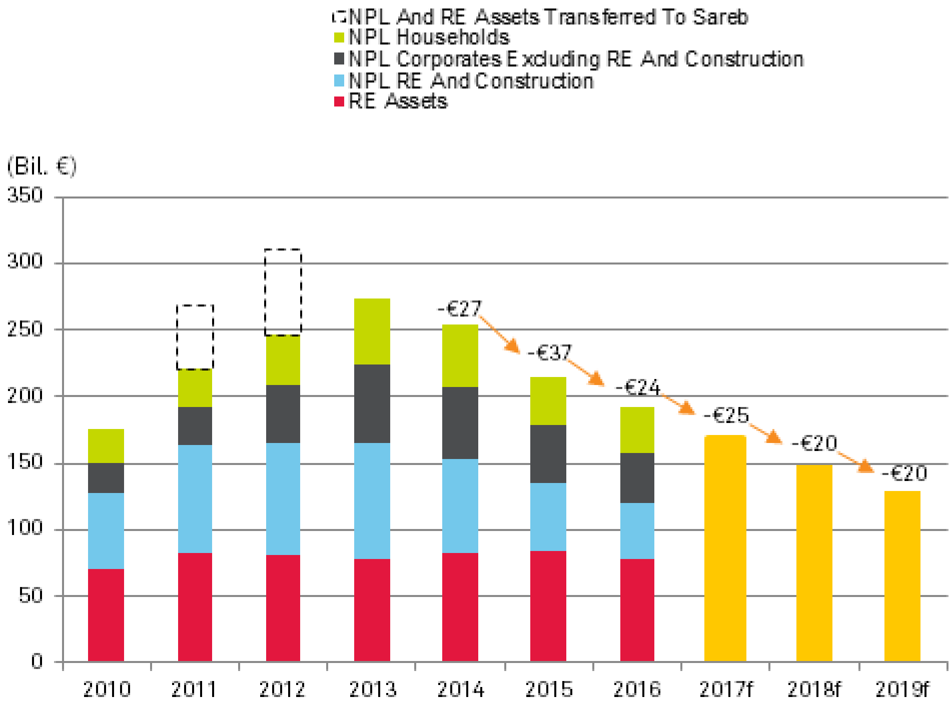
LT--Long-term. Precrisis refers to December 2011. Lowest rating achieved in most cases by year-end 2012. No precrisis rating for Laboral and Abanca, since we assigned the Laboral rating in June 2016 and the Abanca rating in March 2013. Source: S&P Global Ratings.

The disposal of nonperforming assets (NPAs) is key to advancing the workout of legacy issues. In the last four years, the stock of NPAs has steadily declined. We estimate the aggregate reduction at €113 billion since end-2013, which implies a 40% drop from the €282 billion peak in December 2013. In relative terms, progress looks less impressive as total credit outstanding has also dramatically contracted. The system's NPA ratio has dropped to an expected 13.3% of loans from 19.5% over the same period.

But there is still a long way to go. Banks have so far reduced the stock of NPAs without significantly resorting to large disposals. The pace of organic reduction has decelerated year after year, however, which suggests the need for more ambitious initiatives to properly throw off the shackles of the crisis. Up until quite recently, banks' management teams appeared reluctant to accelerate the sale of problematic exposures as they felt the associated credit costs were already recognized. Therefore holding and managing those exposures made economic sense, particularly in light of expectations of a property market recovery and very low financing costs. Banks probably did not fully factor in the cost of maintaining large teams to handle workouts, and the opportunity cost of not focusing on new business.

Chart 2

Evolution Of The Spanish Banking System



f--Forecast. NPL--Nonperforming loan. RE--Real estate. Source: S&P Global Ratings, Bank of Spain data.

That said, the two big sale transactions closed by Spain's largest players, Banco Santander S.A. and Banco Bilbao Vizcaya Argentaria, in 2017 represent a turning point, in our view, and will undoubtedly put pressure on others to follow. We believe the regulator is also very keen to see a faster pace of NPA reduction. Last August, Banco Santander reached an agreement to sell to Blackstone Fund a 51% interest in all the foreclosed assets and real estate-related nonperforming loans of Banco Popular, a portfolio with a gross value of €30 billion. BBVA, in turn, announced in November the sale to Cerberus Capital Management LP of an 80% stake in a joint venture to which all remaining foreclosed assets of the bank (gross value €13 billion) will be transferred.

Both transactions could lead to an aggregate €43 billion reduction of the system's NPAs, while we have assumed that organically the banking system could only reduce the NPA stock by some €20 billion this year (somewhat below our estimate of €25 billion for 2017). If the banking system were to rely only on organic reductions, NPAs would still represent a high 11.5% of loans by December 2018.

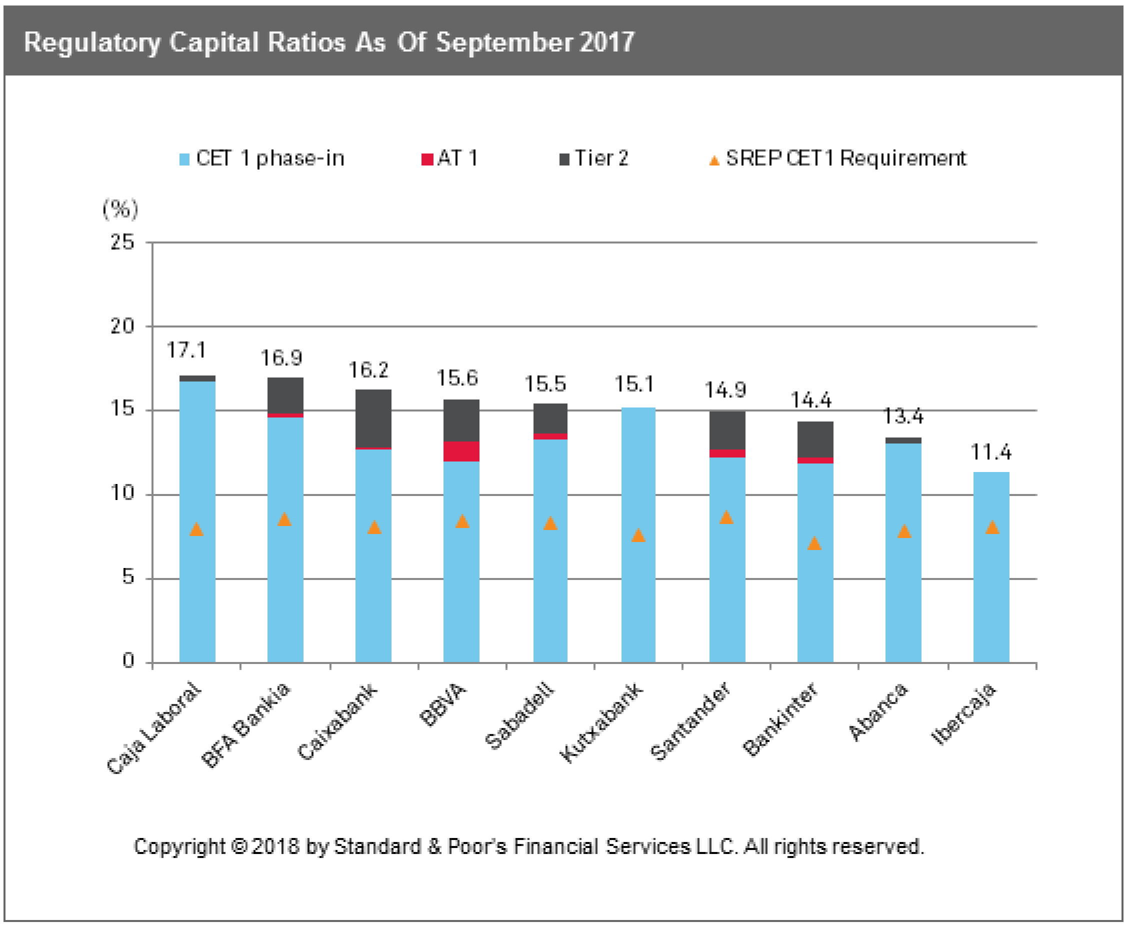
The Capital Build Up Is Set To Continue

Unlike other European peers, which operate comfortably above their desired levels of capital, we expect the process of capital build-up at Spanish banks to continue but gradually. We forecast that the RAC ratios of the Spanish banks we rate will improve on average by about 20 basis points (bps) in 2018.

Higher organic capital generation, even assuming higher pay-outs, modest asset growth, and further issuance of AT1 instruments will help strengthen capital and absorb the impact of the Jan. 1, 2018 implementation of IFRS 9. Most banks--except for BBVA which has already filled its regulatory AT1 capital bucket on a fully-loaded basis--still have room to issue hybrid capital and may take advantage of prevailing favorable funding conditions to do so in 2018. Caixabank, Sabadell, Bankia, and Bankinter tapped the AT1 market for the first time last year.

Our RAC forecasts have some upside potential. They could increase on average by an additional 65 bps (30 bps in the case of larger, geographically diversified players) if we were to conclude that economic risks in Spain have reduced--which the positive trend on our BICRA economic risk assessment indicates is a possibility.

Chart 3



Issuance Of Senior Nonpreferred Debt Will Gain Ground

Banco Santander tapped the senior nonpreferred market for the first time in January 2017, even before the Spanish legal framework recognized the existence of different priority claims within ordinary unsecured senior claims. Through the year, Banco Santander managed to raise almost €10 billion of senior nonpreferred debt via a combination of public and private placements. Santander is ahead of domestic peers on this front because it was the only Spanish bank considered a G-SIB (global systematically important bank) and is therefore required to comply with TLAC requirements on Jan. 1, 2019. The limited timeframe in which to build up cushions of bailinable instruments has placed more pressure on Santander than others.

Upon modification of the Spanish legislative framework in June 2017 (Law Decree 11/2017), which effectively created this new layer of debt-ranking between senior unsecured and subordinated liabilities, BBVA and Caixabank tapped this market with total issuance of €1.8 billion and €1.25 billion, respectively. Both banks took advantage of favorable funding conditions (low rates and high investor interest in the instrument) to start gradually building cushions of bailinable instruments in resolution.

Banks will likely have four more years to build up their minimum requirement for own funds and eligible liabilities (MREL) buffers; the regulator has not formally communicated the requirements in many cases, and there is flexibility under the BRRD to compute existing traditional senior debt as MREL. But even with that in mind, we still foresee strong interest from investors, issuers, and authorities in further developing the senior nonpreferred debt market. Indeed, we think senior nonpreferred debt has the potential to become the preferred funding tool for banks in the coming years, replacing traditional senior debt.

We estimate that rated Spanish banks' issuance of senior nonpreferred debt could amount to €17 billion-€20 billion in 2018 and we expect to see more banks testing this market.

Chart 4

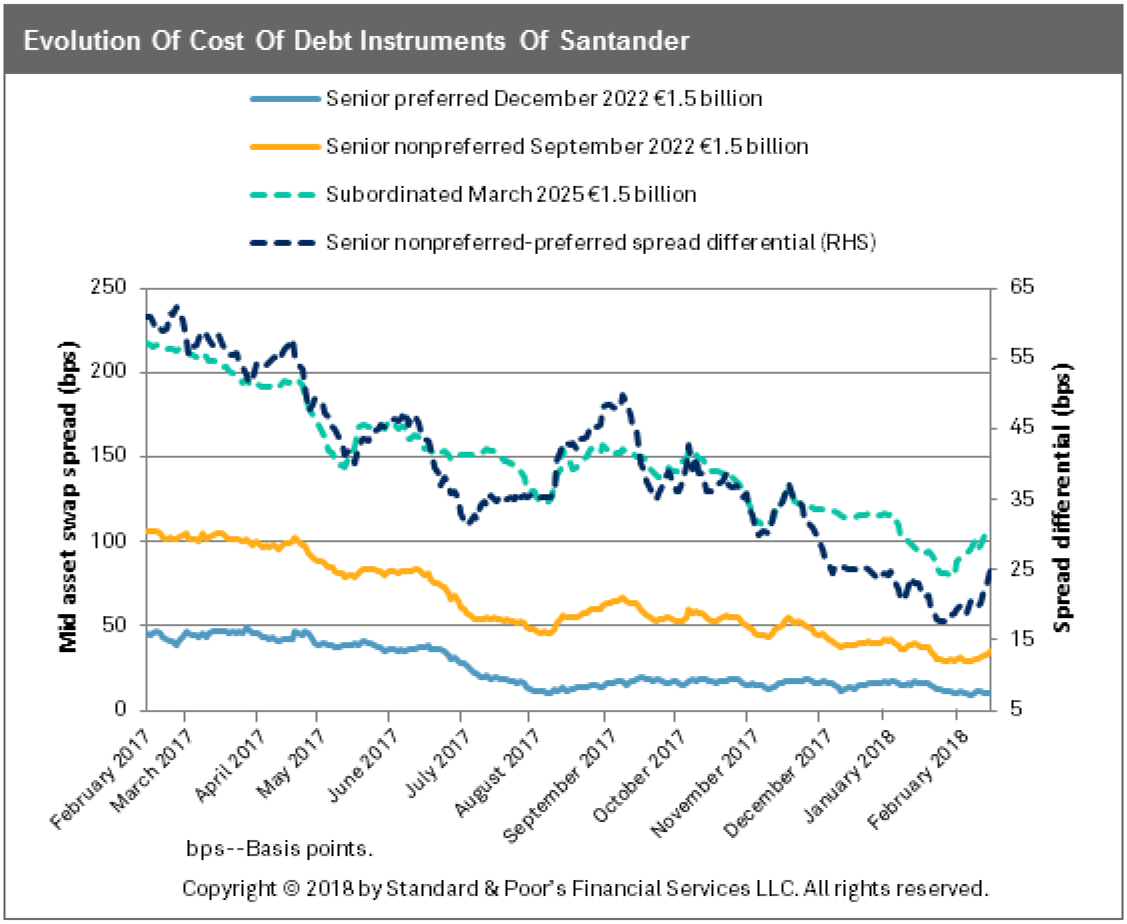
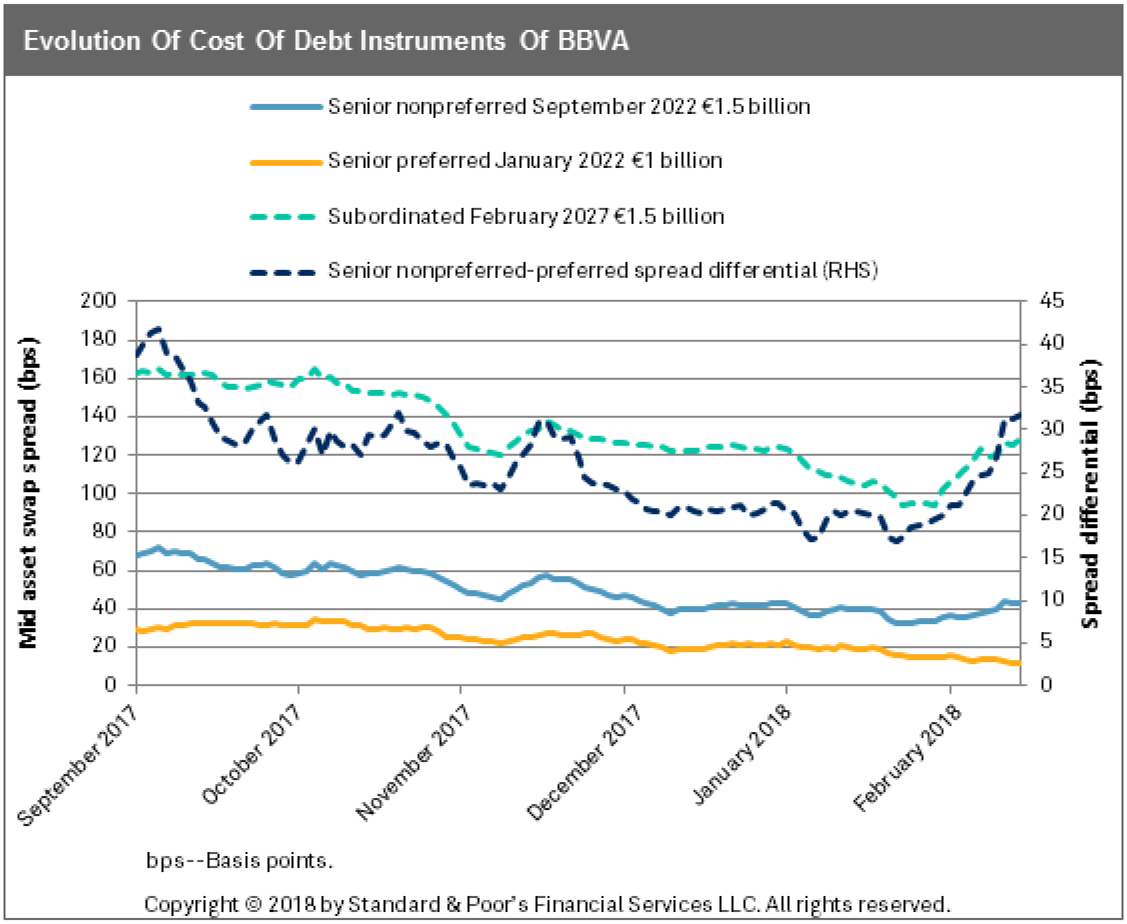

Evolution Of Cost Of Debt Instruments Of Santander
Senior preferred December 2022 €1.5 billion
Senior nonpreferred September 2022 €1.5 billion
Subordinated March 2025 €1.5 billion
Senior nonpreferred-preferred spread differential (RHS)
Mid asset swap spread (bps)
Spread differential (bps)
250
200
150
100
50
0
65
55
45
35
25
15
5
February 2017
March 2017
April 2017
May 2017
June 2017
July 2017
August 2017
September 2017
October 2017
November 2017
December 2017
January 2018
February 2018
bps--Basis points.

Chart 5



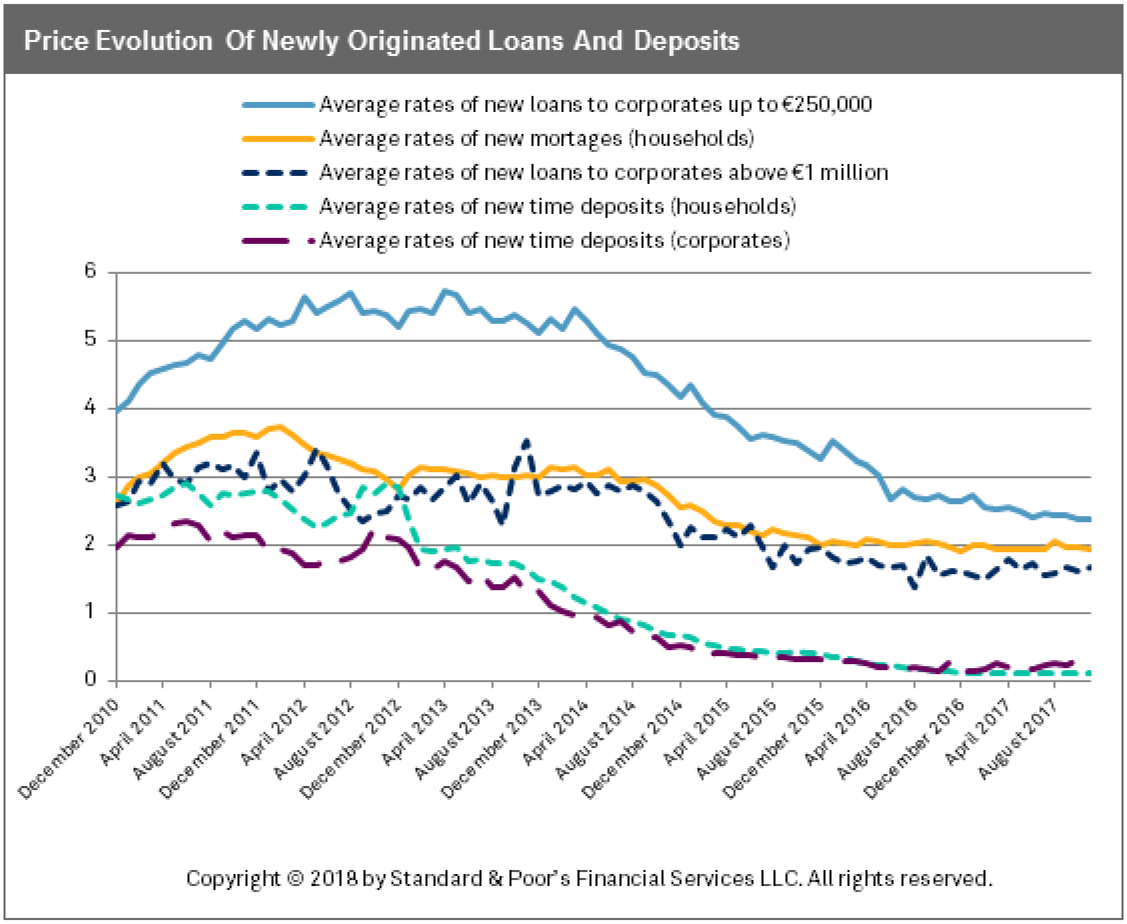
Aligning Banks' Profitability With Their Cost Of Capital Remains A Challenge

We expect banks' bottom-line profitability in 2018 to improve, but only moderately. Lower credit impairments would be the main driver of improved profitability. We forecast the banking system's 2018 credit impairments (including those for real estate assets) at 51 bps of average loans, down from the 76 bps that we estimate pro forma for 2017 excluding the one-off effect of Popular's resolution (reported credit impairments, including Popular, may instead be around 142 bps).

Conversely we see limited upside on the revenue side, particularly for net interest income, although we acknowledge that, unlike previous years, downward pressure will also probably be limited. We expect credit volumes to increase for the first time in several years, but growth to be modest. We forecast 2% growth in the stock of private sector credit (slightly higher growth in the performing portfolio, which probably flattened in 2017). Additionally, reference interest rates, and in particular the 12 months' EURIBOR to which the mortgage book is largely referenced, are unlikely to move much, while price competition is set to remain tough (see chart 6).

The beneficial impact of lower funding costs has almost fully played out. New household deposits are being remunerated at 10 bps, while the remuneration for the whole stock currently stands at 17 bps. Conversely, during 2017, banks seemed to have raised the yield paid on new corporate deposits, particularly on those up to one year, to reach 30 bps in November from 13 bps in January. We also expect the contribution of banks' securities portfolios to continue declining. Up to September 2017, domestic fixed income portfolios generated 17% of banks' interest income, down from 20% in 2016.

Chart 6



We see potential for fee income increasing (as was the case in 2017: up to September fee income grew at an annual 7% rate) but not to the point of materially altering revenue dynamics.

In light of muted revenue growth, we believe banks will maintain tight control over costs. Although banks have already significantly downsized branch networks and staff levels, we expect the process to continue for several years. The integration of BMN into Bankia and the restructuring of Popular will lead to further branch closures, and we anticipate others following suit. BBVA, for example, has communicated its plans to close 179 branches in Spain in 2018. The need to operate more efficiently, coupled with the increasing use of digital channels--which can only grow--is leading managers to constantly reassess the appropriate size of distribution networks.

We expect that the return on equity (RoE) of the Spanish banking system domestic business could improve to

4.5%-5.0% in 2018. While this is a big improvement from the, at best, break-even results we expect in 2017--given the sizable losses Popular reported at mid-year when it was resolved--it will only be a modest improvement compared to the system's returns (excluding the Popular effect), which we estimate at around 4.3%. RoE will still be well below banks' cost of capital, therefore continuing to raise questions about the sustainability of some banks' business models.

There Is A Case For More Consolidation

We think that current market conditions--limited prospects for significant volume growth and low interest rates--and banks' need to ensure that business models are sustainably profitable open the door for more consolidation.

Midsize banks in particular could see consolidation as an opportunity to gain size; strengthen and diversify their franchises; improve efficiency by diluting the impact of fixed-cost bases (including required investment in IT and digitalization) and thereby strengthen profitability; and access the funding markets more easily. Recent history also shows that consolidation can improve industry standards. The Spanish central bank has suggested institutions consider this option rather than waiting for more favorable interest rates, which may take time to materialize.

We acknowledge that the concentrated ownership structure of some banks may act as a constraining factor in this process. Several banks remain owned by one or a few shareholders (in many cases, banking foundations, which may be less demanding in terms of returns than institutional investors). Even this is changing, however. Unicaja, for example, was first listed in 2017. We also see potential market pressure coming from debt investors as banks start selling MREL-eligible debt to them.

However, we doubt that further consolidation will dramatically change the industry's landscape in 2018. Only if Bankia were sold to another entity would the equilibrium of forces in the market change. Our base case, however, is that the government will gradually divest its stake and place it in the market.